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SMALL BUSINESS ADMINISTRATION

13 CFR Part 107

Small Business Investment Companies – Early Stage SBICs

RIN: 3245-AG32

AGENCY: U.S. Small Business Administration

ACTION: Final rule.

SUMMARY: In this final rule, the U.S. Small Business Administration (SBA) is defining a new sub-category of small business investment companies (SBICs) which will focus on making equity investments in early stage small businesses. By licensing and providing SBA leverage to these “Early Stage SBICs,” SBA seeks to expand entrepreneurs’ access to capital and encourage innovation as part of President Obama’s Start-Up America Initiative launched on January 31, 2011. This final rule also sets forth regulations applicable to Early Stage SBICs with respect to licensing, capital requirements, non-SBA borrowing, examination fees, leverage eligibility, distributions, and capital impairment. In addition, the final rule makes certain technical changes to the SBIC regulations.

DATES: This rule is effective [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

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SUPPLEMENTARY INFORMATION:

I. Background Information

On January 31, 2011, President Obama announced the “Start-Up America Initiative” to encourage American innovation and job creation by promoting high-growth entrepreneurship across the country with new initiatives to help encourage private sector investment in job-creating startups and small firms, accelerate research, and address barriers to success for entrepreneurs and small businesses. The SBIC program will play a key role in accomplishing these goals by expanding access to capital for early stage businesses.

Early stage businesses face difficult challenges accessing capital, particularly those without the necessary assets or cash flow for traditional bank funding. Although the venture capital industry provided over \$22 billion in financings to U.S. businesses in calendar year 2010, this represented over a 23% decline from 2007. Less than a third of these financing dollars went to early stage or start-up businesses. Of the financings that went to early stage and start-up, over two-thirds went to businesses located in three states: California, Massachusetts, and New York. (Source: ThomsonOne VentureXpert) As a result, less than 10% of U.S. venture financing dollars went to early stage and start-up businesses not in those three states. SBA will seek to expand access to capital for early stage small businesses throughout the United States by allocating from its current debenture authorization up to \$200 million per year (up to \$1 billion total over five years) beginning in FY 2012 to Early Stage SBICs.

SBA has not typically provided leverage in the form of SBA-guaranteed debentures to SBICs that plan to provide early stage venture capital financing to small businesses. The standard debenture is generally appropriate for investments in small businesses that generate sufficient cash flow to pay interest and/or dividends, so that SBICs in turn can

make semi-annual interest payments on their debentures. Investments in early stage companies, which typically cannot make current interest or dividend payments, do not fit naturally with the structure of debenture leverage.

Furthermore, early stage companies have inherently higher risk; although they can offer potentially higher returns than later stage equity or mezzanine debt investments, the returns are much more volatile. Because the debenture program is required by law to operate at zero cost, the Early Stage SBIC initiative contemplates a number of strategies to mitigate risk and limit the initiative's impact on leverage fees, although fee increases will still be necessary.

On December 9, 2011, SBA published a proposed rule to define an Early Stage SBIC and to establish the features of the Early Stage SBIC initiative. The proposed rule also included several new regulatory provisions intended to reduce the risk that an Early Stage SBIC would default on its leverage and to improve SBA's recovery prospects should a default occur. The preamble to the proposed rule also discussed key aspects of the Early Stage initiative that are not addressed in the regulations, including the limits on the aggregate amount of debenture leverage that will be made available to Early Stage SBICs, and SBA's intention to make leverage available to Early Stage SBICs in two forms: (1) a debenture that requires quarterly interest payments throughout its term; and (2) a debenture that is issued at a discount and does not require interest payments during the first five years of its term.

SBA received ten sets of comments on the proposed rule. Some were general comments on the Early Stage initiative and others were specific to individual sections of the proposed regulations. SBA discusses the comments in the following sections.

II. General Comments

Need for Initiative. SBA received six comments that included general statements of support for the goals of the Early Stage initiative. These commenters agreed with SBA's assessment that there is a gap in the availability of capital for early stage equity investing and that the Early Stage initiative could help to provide early stage small businesses with access to much-needed capital. However, two commenters suggested that SBA address the needs of early stage companies through a new program, separate from the existing SBIC debenture program, to avoid the possibility that failures among higher risk Early Stage SBICs could jeopardize the ability of the current debenture program to operate on a break-even basis. As discussed in the proposed rule, SBA considered seeking legislation to authorize a new program specifically focused on early stage investing, but ultimately chose to pursue an initiative through the existing debenture program because of the compelling need to begin assisting early stage small businesses as quickly as possible.

SBA agrees that the stability of the existing debenture program must be maintained, and has designed the Early Stage initiative with multiple protections to achieve that goal. These protections include: (1) limiting the total leverage committed to Early Stage SBICs to a maximum of \$200 million per year over a five year period; (2) limiting the maximum leverage available to an individual Early Stage SBIC to the lesser of \$50 million or 100 percent of its Regulatory Capital (as opposed to the lesser of \$150 million or 300 percent of Regulatory Capital for standard debenture SBICs); and (3) establishing special distribution rules to require pro rata repayment of SBA leverage when an Early Stage SBIC makes distributions to its investors. The higher risks of early stage investing have been accounted for in the program formulation model which determines the annual

fee needed to keep the debenture program's original subsidy cost at zero, as required by law.

Cost of the Initiative. SBA received four comments expressing concern about the increased leverage fees attributable to the Early Stage initiative. For SBA leverage commitments issued in fiscal year 2012, the initiative adds 13.7 basis points to the annual fee. For fiscal year 2013, the impact of the initiative on the annual fee will be slightly lower, 11.5 basis points, based on updated assumptions. The commenters felt it was unfair or inappropriate to impose the additional costs of the Early Stage initiative on other users of debenture leverage. They indicated that the initiative should not be pursued unless it could break even on a stand-alone basis. Some commenters expressed concern not only about the added cost for fiscal year 2012, but also about the extent to which the annual fee might increase in future years. These commenters noted the large losses that SBA incurred on participating securities, a type of SBA leverage that was offered in the past to SBICs focused on equity investing, much of which was early stage; they also speculated that fees could rise based on the impact of the statutorily mandated "energy saving debentures" that will be available to SBICs making certain types of energy-related investments.

SBA understands that managers of a debenture SBIC may feel that they are being unfairly required to "subsidize" the higher-risk investment strategy of an Early Stage SBIC. However, debenture SBICs already pursue a range of investment strategies that present varying degrees of risk to SBA, yet SBA does not formulate separate fees based on these differences; rather, the leverage fees are calculated based on analysis of the overall SBIC program portfolio. Although the Early Stage initiative does result in a small

increase in the annual fee for all new debenture leverage commitments, the resulting fee of roughly 80 basis points for fiscal year 2012 is well below the statutory maximum of 1.38 percent and is also below the actual fees charged in many previous years.

SBA notes that the fiscal year 2012 annual fee reflects the impact of both the Early Stage initiative and the energy saving debentures. In addition, in developing the Early Stage initiative, SBA gave extensive consideration to the lessons learned from the participating securities program.

Leverage availability. The proposed rule stated that SBA would allocate up to \$200 million of debenture leverage per year to Early Stage SBICs, to a total of up to \$1 billion over a five-year period. Two commenters noted that an Early Stage SBIC may need leverage after its fifth year of operations, because either a portion of its leverage commitment expired or it did not obtain commitments for the full amount of leverage it was eligible for. The commenters stated that SBA should ensure that adequate leverage will be available for Early Stage SBICs throughout their partnership terms.

SBA currently intends to issue commitments for Early Stage debenture leverage only until the end of fiscal year 2016. However, SBA recognizes that it is important for Early Stage SBICs to be able to obtain the leverage for which they are eligible, and will explore various options to ensure availability. These options may include allowing an Early Stage SBIC to apply for a new leverage commitment to replace an expired commitment, provided that SBA has the budget authority to do so, or permitting an Early Stage SBIC to draw the remaining balance of a leverage commitment prior to its expiration, even if does not have a current need for the funds. Because SBA cannot

ensure that any of these options will be available in the future, Early Stage SBICs will need to be prepared to manage their portfolios within the existing limitations.

Capital Impairment. SBA did not propose any exceptions to the existing Capital Impairment regulations for Early Stage SBICs. However, SBA received two comments stating that Early Stage SBICs should receive additional forbearance because of the kind of investments they will be making. The commenters felt that Early Stage SBICs should benefit from the same types of exceptions that the regulations provided for participating securities SBICs, such as a maximum allowable Capital Impairment Percentage (CIP) of 85 percent for the five years after a fund's first issuance of leverage.

SBA believes that adopting this suggestion would result in an unacceptable increase in risk. SBA incurred losses on a large majority of participating securities SBICs that reached an 85 percent CIP, and especially on those that reached 85 percent sooner rather than later. However, SBA recognizes that an Early Stage SBIC is more likely than a regular debenture SBIC to have some early losses that, combined with a lack of current income, may put upward pressure on the CIP even though the fund's overall portfolio ultimately proves to be sound. SBA has considered whether there is a low-risk way to offer Early Stage SBICs more flexibility in their CIP calculation, and believes that a change can safely be made in the treatment of "Class 2" unrealized appreciation. Class 2 appreciation arises when an SBIC holds an investment in a company that subsequently receives a new round of financing at a higher price, provided the new round includes a substantial investment by a sophisticated, new, non-strategic investor in an arm's length transaction. SBA regulations allow Class 2 appreciation (discounted by 50 percent) to

offset realized losses in the CIP computation, but in most cases only for 24 months after the new round of financing takes place.

For Early Stage SBICs, SBA believes the 24-month limit can be made more flexible without increasing program risk. In general, at the end of the initial 24 months, an Early Stage SBIC with “expiring” Class 2 appreciation will be able to request an extension based on an independent third-party valuation of the investment and any other relevant information, as determined by SBA. In addition, in certain instances, based on the valuation of the investment and other relevant information, SBA will permit the Early Stage SBIC to use the Class 2 appreciation in its CIP computation without the 50 percent discount. Full details of these changes are discussed in the section-by-section analysis under new § 107.1845.

SBA believes these capital impairment changes are also responsive in part to a concern that may be implicit in two comments received on proposed § 107.1182, under which SBA has the right to require valuations of an Early Stage SBIC’s investments. In asking how SBA plans to use these valuations and whether SBA will be bound by them, the comments may reflect a concern that SBA is more likely to mandate the write-down of an investment based on a valuation than it is to allow a write-up. While SBA is not adopting a general policy of allowing Early Stage SBICs to write up investments based on independent valuations, this final rule does provide Early Stage SBICs with a degree of assurance that they will continue to receive credit for their Class 2 Appreciation when it is supported by a an acceptable third party valuation.

III. Section by Section Analysis

A. Early Stage initiative provisions

Section 107.50 – Definitions. To implement the Early Stage initiative, SBA proposed to add the defined term “Early Stage SBIC” and revise the existing defined term “Payment Date”.

Early Stage SBIC

SBA received three sets of comments suggesting various changes to the proposed definition. SBA particularly sought input from the public on whether 50 percent was appropriate as the required minimum level of early stage investments, and all comments received on the definition focused on this issue. One commenter suggested that an Early Stage SBIC should be required to invest at least 75 percent of its total financing dollars in small businesses classified as “early stage” at the time of the SBIC's initial investment. The commenter felt that later stage investments would not support the intent of the initiative and could distract SBIC managers from focusing on their early stage investments. The commenter also viewed early stage investing as a specialized skill. In contrast, two other commenters suggested a change in the definition to require at least 25 percent of all financing dollars to be invested in later stage investments structured to produce current income. They thought this change would reduce risk and might eliminate the need for the interest reserve required under § 107.1181, which would increase an Early Stage SBIC's total funds available for investment.

SBA has not adopted either of these comments because it believes the commenters' contrasting points of view illustrate the benefits of maintaining the flexibility that the proposed definition provided. SBA expects that some management teams will focus exclusively on early stage companies, while others will opt for a mixed portfolio. Applicants may propose to manage risk in a number of different ways, including making

some later-stage investments, taking less than one tier of leverage, or using leverage primarily for follow-on investments in portfolio companies that are performing well. SBA believes that fund managers are in the best position to develop an investment strategy based on their own skills, experience and analysis of market opportunities.

The only other comment received on the Early Stage definition was a suggested clarification. Two commenters thought it would be helpful for the definition to refer specifically to § 107.1810(f)(11), which specifies the time frame within which an Early Stage SBIC must satisfy the early stage investment requirement. SBA agrees and has added a cross-reference to the cited section.

The other key points of the definition were that: (1) an Early Stage SBIC must be organized as a limited partnership; and (2) a small business would be considered “early stage” if it has not yet achieved positive cash flow from operations in any full fiscal year. SBA received no comments on these aspects of the definition and is finalizing them without change.

Payment Date

SBA proposed special distribution rules in §107.1180 which would require Early Stage SBICs to make mandatory prepayments of outstanding debentures at the same time they make distributions to their private limited partners. The proposed revision of the “Payment Date” definition in §107.50 designated March 1, June 1, September 1, and December 1 of each year as the dates on which debenture prepayments could be made and required interest payments would be due.

SBA received two comments suggesting a requirement for semi-annual interest payments (the same as for standard debentures), while preserving the option for an Early

Stage SBIC to prepay debentures and make interest payments on a quarterly basis. The commenters reasoned that this added flexibility would be a better fit with the type of investing that Early Stage SBICs will do.

SBA proposed the quarterly Payment Date structure expressly to provide Early Stage SBICs with more frequent distribution opportunities than standard debentures afford. SBA believes that a hybrid structure with both required and optional interest payments would result in excessive administrative burden for SBICs, SBA, and debenture purchasers. Accordingly, SBA is finalizing the Payment Date definition as proposed.

Section 107.210 – Minimum capital requirements for Licensees. Proposed § 107.210(a)(3) required an Early Stage SBIC to have at least \$20 million of Regulatory Capital (consisting of paid-in capital contributions from private investors plus binding capital commitments from Institutional Investors, as defined in existing § 107.50). In comparison, the minimum Regulatory Capital is \$5 million for other debenture SBICs and \$10 million for participating securities SBICs.

Two commenters noted that SBA will consider geographic diversity as one factor in evaluating applicants for an Early Stage SBIC license. Based on the presumption that a fund investing in underserved areas might be able to operate effectively with less than \$20 million of capital, they suggested language that would allow SBA to license an Early Stage SBIC with Regulatory Capital as low as \$10 million, provided SBA is satisfied that the fund would be economically viable.

In the proposed rule, SBA specifically requested public input on the \$20 million private capital minimum. The very limited response to this request suggests that the

proposed minimum capital requirement was acceptable to most readers. Although SBA recognizes that operating costs differ across geographic locations, SBA's experience in the regular debenture program has not shown a strong connection between the geographic areas in which an SBIC plans to invest and the amount of capital it raises. In light of historical data showing that SBA has experienced higher loss rates on smaller SBICs, with performance statistics improving as private capital approaches \$20 million, SBA does not see a compelling reason to reduce the minimum capital requirement and is finalizing § 107.210 as proposed.

Section 107.300 – License application form and fee. Three commenters addressed this section. One commenter expressed concern that small businesses seeking financing from an Early Stage SBIC might be required to pay a \$25,000 fee. That is not the case; the \$25,000 fee would be paid by applicants for an Early Stage SBIC license. The other two commenters each submitted two identical comments. First, they requested clarification that SBA would refund the licensing fee if it did not accept an application for processing. The proposed rule characterized the licensing fee as “non-refundable”; however, if SBA received an application that could not be accepted for processing, and the applicant did not correct the deficiencies, SBA would return the licensing fee along with the application itself. In SBA's experience, this situation has rarely if ever occurred and does not need to be specifically addressed in the regulation. Consistent with current practice, SBA will not refund the fee for an application that is denied, withdrawn, or otherwise dismissed after being accepted for processing.

The commenters also urged SBA to cease adding \$10,000 to the application fee because an applicant is organized as a partnership. The intent of this comment is unclear.

For many years, § 107.300 has included an additional \$5,000 charge for partnerships, and the proposed rule did not change that provision. SBA imposed this additional cost because of the more extensive document review that a partnership application requires. It is possible that the commenters intended to address the \$10,000 difference in the licensing fee for an Early Stage SBIC applicant versus a regular debenture applicant (\$25,000 versus \$15,000, assuming both are organized as partnerships). SBA believes the difference is justified by processing differences between the two types of applications, including compressed processing times for Early Stage applications which will require SBA to supplement its licensing staff with outside consultants. Therefore, the proposed section has been finalized without change.

Section 107.305 – Evaluation of license applicants. In the proposed rule, SBA specifically requested input from the public on the factors used by SBA to evaluate applicants to the SBIC program, including applicants for an Early Stage SBIC license. These factors were grouped in four broad categories: Management qualifications, performance of managers’ prior investments, the applicant’s proposed investment strategy, and the applicant’s proposed organizational structure and fund economics. Only two commenters addressed this section, submitting nearly identical comments. SBA is finalizing the proposed section without change, for the reasons discussed in the following paragraphs.

Proposed § 107.305(a) included experience in “implementing best practices for investment firms” as one aspect of management qualifications that SBA would evaluate. The two commenters described this criterion as an amorphous standard on which there is no consensus, and suggested deleting it. SBA disagrees. SBA believes that many best

practices are widely acknowledged and disseminated by organizations such as the Institutional Limited Partners Association, the National Venture Capital Association, and the Private Equity Industry Guidelines Group.

Proposed § 107.305(b) included “the contribution of prior investments to the growth of portfolio company revenues and number of employees” as one of the factors SBA would consider in evaluating the performance of fund managers' prior investments. The two commenters suggested eliminating employment growth as a criterion because investment funds do not usually track this information. SBA understands that not all fund managers will have employment data for the companies in which they previously invested, and will not disqualify an applicant that does not have these data. However, job growth is a critical part of the SBIC program's mission and SBA believes it should be considered. In fact, the current SBIC license application (which Early Stage SBIC will also use) already requests information on the growth of portfolio company employees and revenues, and most applicants have been able to provide it.

Proposed § 107.305(c) included compliance with SBA regulations as a factor in SBA's evaluation of an applicant's investment strategy; proposed § 107.305(d) similarly included regulatory compliance with respect to an applicant's organizational structure and fund economics. The two commenters felt that compliance was relevant only to applicants that have previously managed an SBIC. However, the provisions relate not to an applicant's prior funds, but to the likelihood of compliance of the strategy and structure of the proposed new SBIC. Therefore, these provisions pertain to all applicants.

Section 107.310 – When and how to apply for licensing as an Early Stage SBIC.

Under proposed § 107.310, SBA would not license two Early Stage SBICs under

common control if both would have SBA leverage or leverage commitments outstanding at the same time. SBA received one comment stating that Early Stage SBIC managers should be able to access leverage across multiple funds at the same time, as this modification would strengthen the community of investment firms and individuals that finance early stage companies. SBA has not adopted this comment because portfolio diversification is particularly important with only a five year licensing period for the Early Stage initiative and a limited total leverage allocation.

The proposed section also provided that SBA would accept Early Stage SBIC applications only during specified periods, which would be announced by Federal Register notice. One commenter thought, depending on the number of applications received, that SBA might turn down applicants even though they meet the qualification standards for licensing. The commenter suggested that any qualified applicant that is not given a green light to apply for an Early Stage SBIC license should receive a green light to apply for a regular debenture SBIC license. An Early Stage SBIC applicant that does not meet the licensing qualification standards is not prohibited from separately pursuing a regular debenture SBIC license.

Section 107.320 – Evaluation of Early Stage SBICs. Proposed § 107.320 stated that SBA would evaluate Early State SBIC applicants using the same set of factors applicable to SBIC applicants in general, as set forth in proposed § 107.305. In addition, proposed § 107.320(a) and (b) added two selection criteria specific to Early Stage SBICs, giving SBA the right to consider: (1) diversification of Early Stage SBICs with respect to “vintage year” (the year in which an investment fund draws its initial capital from investors), and (2) diversification of Early Stage SBICs with respect to geographic

location. SBA received no comments specific to this section and is finalizing it without change.

Section 107.565 – Restrictions on third-party debt of Early Stage SBICs. Proposed § 107.565 required an Early Stage SBIC to obtain SBA approval to have, incur or refinance any third-party debt, whether secured or unsecured. The proposed rule made an exception for “accounts payable from routine business operations”. Two commenters were concerned that “routine business operations” could be interpreted too narrowly; one asked whether it would include certain legal expenses or specialized audit work performed as part of an Early Stage SBIC's due diligence on a potential investment. SBA considers the ordinary expenses of operating an SBIC to come within this exception and other extraordinary expenses would require SBA’s prior approval. SBA is finalizing § 107.565 as proposed.

Section 107.585 – Voluntary decrease in Licensee’s Regulatory Capital. The proposed rule required any reduction of Regulatory Capital under § 107.585 by an Early Stage SBIC to be approved by SBA in writing. SBA received two comments suggesting that an Early Stage SBIC that has repaid all of its leverage should be exempt from this prior approval requirement. The requested exemption is available under existing § 107.1000(b), which applies to all SBICs (including Early Stage SBICs) with no outstanding leverage.

Section 107.692 – Examination fees. SBA received two comments addressing this section. Both suggested that partnership SBICs should not be charged an additional \$10,000 examination fee; however, neither the existing regulations nor the proposed rule included such a fee. The proposed amendments to § 107.692, which SBA is finalizing

without change, require an Early Stage SBIC to pay an examination fee that is 10 percent higher than the base fee until all debenture leverage has been repaid and no further leverage will be issued. The existing regulation also includes a 5 percent addition to the base fee for partnerships. The maximum base fee is \$14,000, so the 5 percent and 10 percent premiums combined cannot exceed \$2,100. SBA charges more for partnerships based on the documentation that must be reviewed; for Early Stage SBICs, SBA expects that the value of unrealized investments will require more review than is needed for other debenture SBICs.

Section 107.1120 – General eligibility requirements for Leverage. Proposed paragraph (k) of this section provided for a new certification by Early Stage SBICs seeking an SBA leverage commitment or draw. The Early Stage SBIC would be required to certify that it will provide at least 50 percent of the aggregate dollar amount of its financings to “early stage” companies, in accordance with the Early Stage SBIC definition in § 107.50. The proposed certification was not specific as to when the early stage investment requirement would be met, and two commenters suggested that the clarity of the provision would be improved by adding a cross-reference to the timing requirements in § 107.1810(f)(11). SBA agrees and has revised the final rule accordingly.

Section 107.1150 – Maximum amount of Leverage for a Section 301(c) Licensee. In this section, SBA proposed special limits on the maximum amount of leverage that will be available to an Early Stage SBIC. Among other limitations, the maximum leverage that an Early Stage SBIC could have outstanding at any time would be limited to 100 percent of its paid-in private capital (“Leverageable Capital”) or \$50 million, whichever is less. SBA received two comments suggesting that Early Stage SBICs

should be able to obtain additional leverage if they invest in low income geographic areas. This benefit is available to other SBICs under existing § 107.1150(c). SBA has not adopted this comment based on its concern that increasing the leverage for which an Early Stage SBIC is eligible would result in increased risk and could ultimately increase the leverage fees that all debenture SBICs must pay.

Section 107.1180 – Required distributions to SBA by Early Stage SBICs. In this section, SBA proposed to add distribution requirements that would apply only to Early Stage SBICs. To reduce the risk of the Early Stage initiative, the proposed rule required an Early Stage SBIC to make a distribution to SBA whenever it made a distribution to its investors. Distributions could be made on any quarterly Payment Date (March 1, June 1, September 1, or December 1). SBA would apply any such distribution to the repayment of the SBIC's outstanding debentures. The Early Stage SBIC would have to be current on its debenture interest and fees before making a distribution. SBA received two comments pointing out a possible conflict in the proposed regulatory language. They noted that proposed § 107.1180 used the existing defined term “Distribution”, which includes “any transfer of cash or non-cash assets to SBA, its agent or Trustee”. Thus, the definition could be presumed to include payments of interest and fees to SBA, which therefore would be subject to the various restrictions on Distributions in the proposed rule. To avoid any confusion, SBA has revised § 107.1180(a) to clarify that Early Stage SBIC with outstanding leverage may pay interest, annual fees, and maturing debenture principal pursuant to the terms of its debentures, and that these payments are not subject to the “Distribution” requirements in § 107.1180.

SBA also received two comments on the provision in proposed § 107.1180(b) that allowed debentures issued by Early Stage SBICs to be prepaid in whole but not in part. The commenters asked how SBA would handle a distribution if the amount received was not sufficient to pay off a debenture in full. SBA has experience with this issue through the participating securities program, which includes many SBICs that have also issued debentures. These SBICs have pre-planned their distributions so that the amount payable to SBA will be the amount needed to pay off one or more debentures in full. SBICs have the flexibility to issue debentures in fairly small increments, and most do so; as a result, it should not be difficult to arrange a distribution so that debenture prepayments work out properly.

Proposed § 107.1180(d) stated that SBA's share of a distribution would depend on the Early Stage SBIC's "highest ratio" of outstanding leverage to Leverageable Capital, and its Capital Impairment Percentage (CIP), as determined under existing § 107.1840. At a CIP of less than 50 percent, distributions would be allocated pro rata (based on the "highest ratio") between SBA (up to the amount of the outstanding debenture leverage) and the Early Stage SBIC's investors. However, if the CIP reached 50 percent or more, SBA would receive 100 percent of any distribution until all outstanding debentures have been repaid. If the Early Stage SBIC reduced its CIP below 50 percent, it could resume distributions to its investors.

SBA received one comment on these distribution priority provisions. The commenter stated that for Early Stage SBICs that maintain a low ratio of leverage to Leverageable Capital (for example, funds that raise \$2 or \$3 of private capital for every \$1 of leverage), SBA should not take all distributions when the CIP reaches 50 percent

because the SBA leverage would still be fully protected. The commenter proposed a variable formula to determine the CIP at which SBA would be entitled to priority in distributions, suggesting that this change would make the Early Stage initiative more attractive to potential investors. SBA believes that a variable threshold introduces too much complexity, but also agrees that an Early Stage SBIC that takes substantially less than one tier of leverage does represent a lower risk to SBA and should receive the benefit of more favorable distribution rules. Accordingly, SBA is revising § 107.1180(d) so that SBA will be entitled to 100 percent of distributions only if the CIP is 50 percent or greater and the Early Stage SBIC's highest leverage ratio is greater than 0.5. In other words, an Early Stage SBIC that uses at least \$2 of private capital for every \$1 of leverage will be permitted to continue making pro rata distributions to SBA and its private investors even if its CIP reaches or exceeds 50 percent, as long as it does not have a condition of capital impairment under § 107.1830.

Section 107.1181 – Interest reserve requirements for Early Stage SBICs. Two commenters addressed this section, which required an Early Stage SBIC to maintain funds in reserve to cover interest and Charges on each of its outstanding debentures over the first five years of its term.

The proposed rule provided an exception to the interest reserve requirement for leverage in the form of a discounted debenture, which will not require cash interest payments during the first five years of its term. Instead, the proceeds received by the Early Stage SBIC when the debenture is issued will be discounted; over the first five years following issuance, the carrying value of the debenture will accrete until it reaches face value, and semi-annual interest payments will be required beginning in year six.

For standard debentures, the proposed rule required a reserve sufficient to pay interest and Charges for the first 21 Payment Dates following issuance of a debenture, and both commenters thought the correct period should be 20 Payment Dates, to correspond to a five year period. However, SBA notes that the first of the 21 Payment Dates will come at the end of a “stub period” that is less than a full quarter. The proposed rule correctly provided for the stub period followed by 20 quarters.

Both commenters suggested that SBA should consider permitting Early Stage SBICs to issue discounted debentures as an alternative to the reserve requirements. SBA clearly stated its intention to do so in the preamble to the proposed rule. In the proposed and final rules, § 107.1181(a) states that the reserve requirement applies only to debentures that require periodic interest payments to SBA during the first five years of their term.

Finally, both commenters recommended that the regulation state explicitly that the required reserve on a debenture will be reduced each time the issuing Early Stage SBIC makes an interest payment. SBA believes this point is implicit in the regulation (it was also made explicitly in the preamble to the proposed rule), but has added it to the final rule for avoidance of doubt.

Section 107.1182 – Valuation requirements for Early Stage SBICs based on Capital Impairment Percentage. This section would require an Early Stage SBIC to notify SBA in writing if it has a Capital Impairment Percentage of at least 50 percent, even if its maximum allowable CIP is higher. When SBA receives this notification, or makes its own determination that the CIP is at least 50 percent, SBA would have the right to require the Early Stage SBIC to engage a third party valuation expert, acceptable to SBA, to

perform valuations of some or all of the licensee's investments, as determined by SBA. Two commenters asked how SBA plans to use the valuations, and whether Early Stage SBICs will be able to contest them. SBA has not adopted standard procedures for acting upon third-party valuations, in part because valuations are often provided in ranges and have varying degrees of uncertainty associated with them. SBA will use the valuations as additional data points to assess the Early Stage SBIC's financial condition and the repayment prospects of outstanding SBA leverage, as it currently does with valuations for other debenture SBICs. SBICs always have the right to provide additional information if they disagree with a valuation.

Section 107.1810 – Events of default and SBA's remedies for Licensee's noncompliance with terms of Debentures. SBA proposed four changes in this section that would apply only to Early Stage SBICs. SBA received no specific comments on this section and is finalizing it as proposed. The change is a revision of § 107.1810(f)(2), which provides that an improper distribution made by an SBIC is an event of default. In the final rule, § 107.1810(f)(2)(iv) adds distributions by Early Stage SBICs, as permitted under proposed § 107.1180, to the list of specific distributions that would not be considered improper distributions.

Second, under § 107.1810(f)(11), it is an event of default if an Early Stage SBIC fails to meet the requirement to invest at least 50 percent of its financing dollars in early stage companies, as defined under the proposed Early Stage SBIC definition in § 107.50. This provision would require an Early Stage SBIC to meet the 50 percent requirement as soon as the total dollars invested to date are equal to or greater than Regulatory Capital. Third, under proposed new § 107.1810(f)(12), it would be an event of default if an Early

Stage SBIC fails to maintain the interest reserve required under proposed § 107.1181, as discussed earlier in this preamble.

The conditions in proposed § 107.1810(f)(11) and (f)(12) would both be in the category of events of default with opportunity to cure. If the Early Stage SBIC fails to cure to SBA's satisfaction, SBA could invoke the remedies in existing § 107.1810(g), which include the right to declare outstanding debenture leverage immediately due and payable.

Finally, § 107.1810(j) provides SBA with additional remedies to help maximize recoveries from Early Stage SBICs that have been transferred to a liquidation status. Under this section, if SBA must honor its guarantee and pay the interest and principal of an Early Stage SBIC's debentures, upon such payment SBA has the right to prohibit the SBIC from making additional investments without SBA approval (except for any investments the SBIC had already legally committed itself to make); to prohibit Distributions by the SBIC to any party other than SBA until all leverage and other amounts due to SBA have been repaid; to require all the SBIC's investor commitments to be funded at the earliest time(s) permitted under the SBIC's limited partnership agreement and other applicable documents; to review and re-determine the SBIC's approved Management Expenses (as defined in existing § 107.520); and to the appointment of SBA or its designee as receiver for the SBIC. The receivership would be for the purpose of continuing the SBIC's operations; the appointment of a liquidating receiver is governed by existing provisions of the Small Business Investment Act and is not affected by this rule.

Section 107.1830 – Licensee’s Capital Impairment – definitions and general requirements. As discussed in the preamble to the proposed rule, SBA did not propose to change the maximum permitted Capital Impairment Percentages set forth in § 107.1830. Under the existing regulation, the maximum allowable CIP for a debenture SBIC with one tier of leverage or less is 70 percent. SBA received one comment suggesting that the maximum allowable CIP should be raised to 80 percent for an Early Stage SBIC with a highest leverage ratio of 0.4 or less. SBA agrees that a lower leverage ratio corresponds to lower credit risk, but has declined to adopt this suggestion, primarily because the CIP formula already allows a fund with a low leverage ratio to incur substantially higher dollar losses than a more highly leveraged fund of the same size before becoming impaired. For example, an Early Stage SBIC with \$30 million of private capital and \$30 million of leverage (i.e., a leverage ratio of 1.0) would be impaired (based on a CIP of 70 percent) if it incurred total net losses of \$21 million. In contrast, an Early Stage SBIC with \$40 million of private capital and \$20 million of leverage (i.e., a leverage ratio of 0.5), and the same \$21 million of losses, would have a CIP of only 52.5 percent and would not be impaired.

Section 107.1840 – Computation of Licensee’s Capital Impairment Percentage. SBA did not propose any changes to this section, but is making one change in this final rule in response to comments regarding the need for more flexible capital impairment regulations for Early Stage SBICs. As discussed under “General Comments” in section II of this preamble, SBA is adding an exception for Early Stage SBICs that affects the way Class 2 appreciation is accounted for in the computation of the Capital Impairment

Percentage. In § 107.1840(d)(3)(iii) and (d)(4), the final rule provides for the exception and refers the user to new § 107.1845 for the applicable information.

Section 107.1845 – Computation of Capital Impairment Percentage for Early Stage SBICs. This new section provides the specific details of a change in the treatment of Class 2 appreciation for Early Stage SBICs. This section represents an exception, for Early Stage SBICs only, to certain provisions of existing § 107.1840(d). Under § 107.1840(d)(3), appreciation qualifies as Class 2 only if it is based on a financing that occurred within 24 months of the date when the SBIC is computing its CIP, or if the financed small business meets a test for positive net operating cash flow. Under § 107.1840(d)(4), an SBIC can use 50 percent of its Class 2 appreciation in the calculation of its “adjusted unrealized gain”, which in turn is the amount that the SBIC can use to offset realized losses in the CIP computation.

Under § 107.1845, at the end of the initial 24 months, an Early Stage SBIC with “expiring” Class 2 appreciation will be able to request an extension. In considering this request, SBA may obtain its own valuation of the investments or require the Early Stage SBIC to obtain a valuation performed by an independent third party acceptable to SBA. SBA may also consider any other information that it deems relevant. If supported by the valuation and other information, SBA may grant an extension allowing the Early Stage SBIC to use all or part of the original Class 2 appreciation for up to an additional 24 months; reasons for granting a shorter or no extension might include a high degree of uncertainty associated with the valuation or the expectation that events occurring within a shorter period will further clarify or determine a company’s value. At the end of any extension period, the Early Stage SBIC could request a further extension, repeating the

original steps. SBA may reconsider its approval of an extension at any time based on new information that may affect the value of an investment.

At the time of any extension request, an Early Stage SBIC will also be able to request an exception to the requirement to discount Class 2 appreciation by 50 percent in the “adjusted unrealized gain” calculation. SBA may grant this exception based on its consideration of relevant information, including its determination that the appreciation on the Early Stage SBIC’s investment, based on its current fair value, is at least two times the original Class 2 appreciation. If the exception is granted, the Early Stage SBIC will be able to use the original Class 2 appreciation in its CIP computation without the 50 percent discount, for the duration of the extension period.

B. Technical changes to regulations

Section 107.130 – Requirement for qualified management. SBA proposed one clarification in this section, which has been finalized without change. The revision makes clear that a licensed SBIC (including an Early Stage SBIC) must have qualified management not only when applying for a license, but as long as it holds the license.

Section 107.1130 – Leverage fees and additional charges payable by Licensee. This section, which SBA is finalizing as proposed, includes two changes to bring the regulation into conformity with statutory requirements for determining the annual Charge to be paid by SBICs on their outstanding SBA leverage.

IV. Justification for Immediate Effective Date

The Administrative Procedure Act (APA), 5 U.S.C. 553(d) (3), requires that “publication or service of a substantive rule shall be made not less than 30 days before its

effective date, except * * * as otherwise provided by the agency for good cause found and published with the rule.”

The purpose of this provision is to provide interested and affected members of the public sufficient time to adjust their behavior before the rule takes effect. In the case of this rulemaking, however, there should be no need for any member of the public, including any SBIC, to make any changes in order to prepare for the rule taking effect. This rule implements changes to the SBIC program to stimulate private sector investment in early stage companies, which are expected to contribute to the important goals of creating jobs and fostering innovation. Any further delay in making leverage available to Early Stage SBICs will only hold back the potential benefits of investment in early stage small businesses. SBA therefore finds that there is good cause for making this rule effective immediately instead of observing the 30-day period between publication and effective date.

Compliance with Executive Orders 12866, 12988 and 13132, the Paperwork Reduction Act (44 U.S.C. Ch. 35) and the Regulatory Flexibility Act (5 U.S.C. 601-612)
Executive Order 12866

The Office of Management and Budget has determined that this rule is a “significant” regulatory action under Executive Order 12866. In the proposed rule, SBA set forth its initial regulatory impact analysis, which addressed the following: (1) Necessity of the regulation; (2) alternative approaches to the proposed rule; and (3) the potential benefits and costs of the regulation. SBA received comments which addressed both alternative approaches to and potential costs of the regulation. Those comments are discussed in the final Regulatory Impact Analysis set forth below:

1. Necessity of Regulation

The Small Business Investment Act of 1958 identifies the SBIC program's mission as follows: "to stimulate and supplement the flow of private equity capital and long-term loan funds which small business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply..." Based on venture capital industry data (ThomsonOne VentureXpert), SBA believes that early stage businesses lack access to needed financing capital. Although the venture industry provided over \$22 billion in financings to U.S. businesses in calendar year 2010, this represented over a 23% decline from 2007. Less than a third of these financing dollars went to early stage or start-up businesses. Given the decline in venture capital financings over the past 3 years, SBA seeks to expand access to early stage businesses by implementing an initiative to provide up to \$1 billion in debenture leverage over five years (beginning in FY 2012) to a limited number of SBICs focused on early stage investments.

If SBA debenture leverage is to be used to finance early stage small businesses, the high risk associated with such investments indicates the need for more protections than those provided by the standard SBIC debenture and current regulations to mitigate risk and cost to the taxpayer. This final rule includes a number of regulatory changes to manage the risks associated with an early stage portfolio, including: (1) limiting leverage for an individual Early Stage SBIC to 100 percent of Regulatory Capital or \$50 million, whichever is less; (2) establishing special distribution rules to require repayment of leverage whenever an Early Stage SBIC makes distributions to its investors; and (3) implementing risk monitoring actions appropriate to SBA's leverage guarantor/creditor

status. Even with these actions, in order to maintain an initial subsidy rate of zero for the debenture program while limiting the increase in leverage fees, SBA can only issue leverage to Early Stage SBICs as a very small percentage of its portfolio.

2. Alternative Approaches to Regulation

SBA considered several alternatives to these regulations. The first alternative was for SBA not to pursue the Early Stage initiative and continue with its current credit policy of not providing debenture leverage to SBICs that focus on early stage equity investing. SBA rejected this alternative because of the critical need for early-stage funding, particularly in the \$1 to \$5 million range that fits well with SBA's small business size standards.

SBA also considered seeking legislation for a new program specifically focused on investing in early stage small businesses. Although such an alternative could have provided an opportunity to introduce useful risk-management provisions, such as SBA profit sharing, SBA chose not to pursue this alternative because of the compelling need to begin assisting early stage small businesses as quickly as possible. A third alternative was for SBA to modify its credit policies to license and approve leverage to qualified early stage focused SBICs without changes in program regulations or in the terms of debenture leverage. SBA believes that doing so would not be financially responsible and would present an excessively high risk of losses to the taxpayer. Ultimately, SBA decided that it could responsibly license a limited number of early stage SBICs after implementing appropriate regulatory changes to manage the associated risk.

In proposing the definition for an Early Stage SBIC, SBA considered both the type of investment that should qualify as "early stage" and whether an Early Stage SBIC's

portfolio should be limited to early stage investments exclusively. Many small businesses in the earliest stages of product development (“seed stage” companies) could benefit from access to additional capital. However, SBA chose not to limit the Early Stage initiative to seed stage investments because of their high risk and the long holding periods they typically require. Although Early Stage SBICs would not be prohibited from investing in seed stage companies, to use SBA debenture leverage successfully they will likely need to start generating cash returns on investments within 4 to 6 years after licensing. This timing concern is also why the proposed definition required only 50 percent of an Early Stage SBIC's portfolio to be in early stage investments. SBA received one comment suggesting that Early Stage SBICs should be required to invest at least 75% of their investment dollars in early stage small businesses. However, two other commenters believed not only that the 50% requirement was sufficient, but that SBA should also consider requiring an Early Stage SBIC to invest at least 25% of its total financing dollars in current pay investments in later stage businesses. The commenters felt this would decrease the risks of Early Stage SBICs, thereby lowering the costs, and could perhaps offset the need for an interest reserve. SBA believes these varying points of view illustrate that fund managers are in the best position to identify the portfolio mix that would be best suited to their skills and experience, and has finalized the Early Stage SBIC definition as proposed.

In determining the maximum amount of leverage for which an Early Stage SBIC would be eligible, SBA decided that a one-to-one match between leverage and private capital (one “tier” of leverage) would provide the best balance between program cost and attractiveness to fund managers and investors. A second tier of leverage would result in a

much higher projected loss rate, and a correspondingly greater increase in annual leverage fees for all debenture SBICs receiving new leverage commitments. SBA also considered a model in which SBA would have provided only half a tier of leverage. This lower ratio of leverage to private capital would have a much lower impact on leverage fees but would be unlikely to attract some high quality fund managers and investors.

SBA also considered various dollar limits on the maximum leverage available to an Early Stage SBIC, in order to avoid an excessive concentration of risk in a small number of funds. A low dollar limit could allow more funds to be licensed, but could be unattractive to stronger applicants with the ability to raise and deploy larger amounts of capital. SBA believes the proposed limit of \$50 million is sufficient to attract high quality applicants. SBA also believes that \$50 million of leverage, in combination with at least \$50 million of private capital, is more than adequate to support a primarily early stage portfolio, with most financings expected to be in the \$1 to \$5 million range.

3. Potential Benefits and Costs

SBA anticipates that this rule will provide significant benefit to early stage small businesses seeking investments by Early Stage SBICs. In estimating the impact, SBA considered that \$1 billion in anticipated leverage will be matched by a minimum of \$1 billion in private capital over the next 5 years, beginning in FY 2012. SBA expects that Early Stage SBICs will invest over a 5 to 7 year period after licensing. Allowing for payment of management expenses and interest, SBA estimates that the \$1 billion in leverage guaranteed by the Early Stage initiative will result in approximately \$125 million annually in financings to small businesses over an 8 to 10 year period.

As stated in the proposed rule, Early Stage debentures will impose additional cost in the form of increased annual fees on all debenture SBICs seeking new leverage commitments. The estimated cost has been incorporated into the program formulation model which determines the annual fee needed to keep the debenture program's original subsidy cost at zero, as required by law. For FY 2012, SBA has budgeted \$150 million in leverage commitments to Early Stage SBICs, within the anticipated appropriated SBIC Debenture loan levels, representing approximately 7 percent of total expected debenture commitments. This 7 percent allocation would increase the annual fee on all new debenture commitments by approximately 13.7 basis points. For FY 2013, SBA has budgeted \$200 million in leverage commitments to Early Stage SBICs, representing approximately 8.3 percent of all new expected debenture commitments. This 8.3 percent allocation would increase the annual fee on all new debenture commitments by approximately 11.5 basis points using updated model assumptions. The fee increases reflect the additional risk associated with the early stage equity investments contemplated by the Early Stage initiative. Early stage investing is higher-risk than the typical SBIC portfolio, and would have required fees in excess of statutory caps if operated on a stand-alone basis. To align fees and costs to the taxpayers with the overall policy goals, the Early Stage initiative incorporates terms designed to mitigate risk, and is limited to no more than \$200 million per fiscal year to keep the annual fees at reasonable levels. The cost is expected to vary each year based on the factors and assumptions used to develop the annual fee, including the total amount of debenture leverage commitments estimated, the amount committed to Early Stage SBICs, and interest rates.

Executive Order 12988

This action meets applicable standards set forth in section 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden. The action does not have retroactive or presumptive effect.

Executive Order 13563

A description of the need for this regulatory action and benefits and costs associated with this action is included above in the Regulatory Impact Analysis under Executive Order 12866.

In connection with the launch of the President's "Start-Up America Initiative", SBA announced its commitment to making financing available to early stage small businesses through the SBIC program. In an effort to engage interested parties in this regulatory action, SBA has since made presentations at SBIC association meetings, Start-up America-related public events, and venture capital industry forums to discuss both the market need for new sources of early stage financing and key issues associated with the design of the Early Stage initiative. SBA announced a series of public webinars regarding the Early Stage Initiative during the comment period. 76 FR 81430 (December 28, 2011). SBA also placed explanatory material on its website to assist the public with understanding the program, as proposed. <http://www.sba.gov/content/early-stage-small-business-investment-company-sbic-initiative>. The public webinars attracted a range of participants, including individuals with prior experience managing either participating securities SBICs or non-SBIC equity funds; SBIC industry service providers; and current debenture program participants. The webinar presentations provided a general introduction to the SBIC program as well as to the goals and proposed structure of the Early Stage initiative. Among other things, participants asked questions about the

timetable for implementing the initiative, when an Early Stage SBIC applicant would have to complete its fundraising, and procedures for submitting license application and obtaining a leverage commitment. Participants were broadly supportive of using the SBIC program to expand the financing options available to early stage small businesses, while adding key protective provisions to manage program risk.

Executive Order 13132

SBA has determined that this final rule will not have substantial, direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, for the purposes of Executive Order 13132, Federalism, SBA has determined that this final rule has no federalism implications warranting the preparation of a federalism assessment.

Paperwork Reduction Act, 44 U.S.C. Ch. 35

SBA has determined that this final rule will not impose additional reporting or recordkeeping requirements. Early Stage SBIC applicants will submit the same license application form as other SBIC program applicants (OMB Control Number 3245-0062). Post-licensing, Early Stage SBICs will have the same recordkeeping and reporting requirements as any other licensed SBIC.

Regulatory Flexibility Act, 5 U.S.C. 601-612

When an agency promulgates a rule, the Regulatory Flexibility Act (5 U.S.C. 601-612) requires the agency to prepare a final regulatory flexibility analysis (FRFA) describing the potential economic impact of the rule on small entities and alternatives that may minimize that impact. Section 605 of the RFA allows an agency to certify a rule, in

lieu of preparing a FRFA, if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities. This final rule affects all SBICs issuing debentures, of which there are approximately 150, most of which are small entities. Therefore, SBA has determined that this final rule will have an impact on a substantial number of small entities. However, SBA has determined that the impact on entities affected by the rule will not be significant. SBA intends to maintain the SBIC program's initial subsidy cost to taxpayers at zero by charging up front and annual fees on its leverage. SBA calculates the annual fee each year using historical data to assess the appropriate fee to offset expected losses. The actual costs for SBIC guarantees may be higher or lower, and SBA will monitor program performance closely. Because SBA expects Early Stage SBICs to be riskier than standard SBICs, the annual fees needed to keep the debenture program's original subsidy cost at zero are higher than if there were no Early Stage SBICs. For FY 2012, SBA estimates \$150 million in leverage commitments to Early Stage SBICs, which increases the annual fee charged to all SBICs seeking new debenture commitments by approximately 13.7 basis points. For FY 2013, SBA estimates \$200 million in leverage commitments to Early Stage SBICs, which increases the annual fee charged to all SBICs seeking new debenture commitments by approximately 11.5 basis points. Since annual leverage fees were introduced in FY 1998, the annual fee has ranged from a high of 100 basis points (1 percent) to a low of 29 basis points, with a 13-year median of 88 basis points. Although the cost will vary in the future based on economic factors and assumptions used to develop the annual fee, SBA expects the fee to remain under 1 percent, comparable to historical annual fees and below the statutory maximum of 1.38 percent. For debenture leverage committed and drawn by

SBICs in FY 2012, SBA estimates that the sum of the debenture interest rate plus the annual fee will be in the vicinity of 5 percent. Debenture SBICs typically use the proceeds of debenture leverage to make loans to small businesses at interest rates in the 12 to 16 percent range, providing them with a significant spread over their cost of funds. Accordingly, the Administrator of the SBA hereby certifies that this final rule will not have a significant impact on a substantial number of small entities. In the proposed rule, SBA solicited comments from the public regarding any perceived significant impact, either on SBICs or on companies that receive funding from SBICs, and received none.

List of Subjects in 13 CFR Part 107

Investment companies, Loan programs-business, Reporting and recordkeeping requirements, Small businesses.

For the reasons stated in the preamble, SBA amends part 107 of title 13 of the Code of Federal Regulations as follows:

PART 107 - SMALL BUSINESS INVESTMENT COMPANIES

1. The authority citation for part 107 continues to read as follows:

Authority: 15 USC 681 et seq., 683, 687(c), 687b, 687d, 687g, 687m and Pub. L. 106-554, 114 Stat. 2763; and Pub. L. 111-5, 123 Stat. 115.

2. Amend §107.50 by adding a definition of “Early Stage SBIC” and revising the definition of “Payment Date” to read as follows:

§ 107.50 Definition of terms.

* * * * *

Early Stage SBIC means a Section 301(c) Partnership Licensee, licensed pursuant to § 107.310 of this part, in which at least 50 percent of all Loans and Investments (in dollars) must be made to Small Businesses that are “early stage” companies at the time of

the Licensee's initial Financing (see also § 107.1810(f)(11)). For the purposes of this definition, an "early stage" company is one that has never achieved positive cash flow from operations in any fiscal year.

* * * * *

Payment Date means:

(1) For a Participating Securities issuer, each February 1, May 1, August 1, and November 1 during the term of a Participating Security, or

(2) For an Early Stage SBIC, each March 1, June 1, September 1, and December 1 during the term of a Debenture.

* * * * *

3. Amend §107.130 by revising the first sentence to read as follows:

§ 107.130 Requirement for qualified management.

When applying for a license, and while you have a license, you must show, to the satisfaction of SBA, that your current or proposed management team is qualified and has the knowledge, experience and capability necessary for investing in the types of businesses contemplated by the Act, the regulations in this part 107, and your business plan. * * *

4. Amend §107.210 by revising paragraph (a)(1) subject heading and the first sentence of its introductory text and by adding a paragraph (a)(3) to read as follows:

§ 107.210 Minimum capital requirements for Licensees.

(a) * * *

(1) Licensees other than Participating Securities issuers and Early Stage SBICs.

Except for Participating Securities issuers and Early Stage SBICs, a Licensee must have Regulatory Capital of at least \$5,000,000. * * *

* * * * *

(3) Early Stage SBICs. An Early Stage SBIC must have Regulatory Capital of at least \$20 million.

* * * * *

5. Amend §107.300 by revising the introductory text and adding a paragraph (d) to read as follows:

§ 107.300 License application form and fee.

The license application must be submitted on SBA Form 2181 together with all applicable exhibits on SBA Form 2182 and a non-refundable processing fee computed as follows:

* * * * *

(d) All applicants seeking to be licensed as Early Stage SBICs will pay the fee for a Partnership Licensee plus an additional \$10,000 fee, for a total of \$25,000.

6. Add § 107.305 to subpart C to read as follows:

§ 107.305 Evaluation of license applicants.

SBA will evaluate a license applicant based on the submitted application materials, any interviews with the applicant's management team, and the results of background investigations, public record searches, and other due diligence conducted by SBA and other Federal agencies. SBA's evaluation will consider factors including the following:

(a) Management qualifications, including demonstrated investment skills and experience as a principal investor; business reputation; adherence to legal and ethical standards; record of active involvement in making and monitoring investments and assisting portfolio companies; successful history of working as a team; and experience in developing appropriate processes for evaluating investments and implementing best practices for investment firms.

(b) Performance of managers' prior investments, including investment returns measured both in percentage terms and in comparison to appropriate industry benchmarks; the extent to which investments have been realized as a result of sales, repayments, or other exit mechanisms; and the contribution of prior investments to the growth of portfolio company revenues and number of employees.

(c) Applicant's proposed investment strategy, including clarity of objectives; strength of management's rationale for pursuing the selected strategy; compliance with this part 107 and applicable provisions of part 121 of this chapter; fit with management's skills and experience; and the availability of sufficient resources to carry out the proposed strategy.

(d) Applicant's proposed organizational structure and fund economics, including compliance with this part 107; soundness of financial projections and underlying assumptions; a compensation plan that provides managers with appropriate economic incentives; a reasonable basis for allocations of profits and fees to Persons not involved in management; and governance procedures that provide appropriate checks and balances.

7. Add § 107.310 to subpart C to read as follows:

§ 107.310 When and how to apply for licensing as an Early Stage SBIC.

From time to time, SBA will publish a Notice in the Federal Register, inviting the submission of applications for licensing as an Early Stage SBIC. SBA will not consider an application from an Early Stage SBIC applicant that is under Common Control with another Early Stage SBIC applicant or an existing Early Stage SBIC (unless it has no outstanding Leverage or Leverage commitments and will not seek additional Leverage in the future). Applicants must comply with both the regulations in this part 107 and any requirements specified in the Notice, including submission deadlines. The Notice will specify procedures for a particular application period.

8. Add § 107.320 to subpart C to read as follows:

§ 107.320 Evaluation of Early Stage SBICs.

SBA will evaluate an Early Stage SBIC license applicant based on the same factors applicable to other license applicants, as set forth in § 107.305, with particular emphasis on managers' skills and experience in evaluating and investing in early stage companies. In addition, SBA reserves the right to maintain diversification among Early Stage SBICs with respect to:

- (a) The year in which they commence operations, and
- (b) Their geographic location.

9. Add § 107.565 to subpart E to read as follows:

§ 107.565 Restrictions on third-party debt of Early Stage SBICs.

If you are an Early Stage SBIC and you have outstanding Leverage or a Leverage commitment, you must get SBA's prior written approval to have, incur, or refinance any third-party debt other than accounts payable from routine business operations.

10. Amend §107.585 by revising the first sentence to read as follows:

§ 107.585 Voluntary decrease in Licensee's Regulatory Capital.

You must obtain SBA's prior written approval to reduce your Regulatory Capital by more than two percent in any fiscal year, unless otherwise permitted under §§ 107.1560 and 107.1570, provided however, that if you are an Early Stage SBIC, you must obtain SBA's prior written approval for any reduction of your Regulatory Capital, including any reduction pursuant to a Distribution under § 107.1180 of this part. * * *

11. Amend §107.692 by redesignating paragraphs (c)(4) and (5) as paragraphs (c)(5) and (6), adding a new paragraph (c)(4), and revising the table in paragraph (d) to read as follows:

§ 107.692 Examination fees.

* * * * *

(c) * * *

* * * * *

(4) If you are an Early Stage SBIC with outstanding Leverage or Leverage commitments, you will pay an additional charge equal to 10% of your base fee;

* * * * *

(d) * * *

Examination fee discounts	Amount of discount-- % of base examination fee	Examination fee additions	Amount of Addition-- % of base examination fee
No prior violations	15	Partnership or limited liability company	5
Responsiveness	10	Participating Security Licensee	10
		Records/Files at multiple locations	10
		Early Stage SBIC	10

* * * * *

12. Amend §107.1120 by adding paragraph (k) to read as follows:

§ 107.1120 General eligibility requirements for Leverage.

* * * * *

(k) If you are an Early Stage SBIC, certify in writing that in accordance with § 107.1810(f)(11), at least 50 percent of the aggregate dollar amount of your Financings will be provided to “early stage” companies as defined under the definition of Early Stage SBIC in § 107.50 of this part.

13. Amend §107.1130 by revising the first sentence of paragraph (d)(1) and the first sentence of paragraph (d)(2) to read as follows:

§ 107.1130 Leverage fees and additional charges payable by Licensee.

* * * * *

(d) * * *

(1) Debentures. You must pay to SBA a Charge, not to exceed 1.38 percent per annum, on the outstanding amount of your Debentures issued on or after October 1, 1996, payable under the same terms and conditions as the interest on the Debentures. * * *

(2) Participating Securities. You must pay to SBA a Charge, not to exceed 1.46 percent per annum, on the outstanding amount of your Participating Securities issued on or after October 1, 1996, payable under the same terms and conditions as the Prioritized Payments on the Participating Securities. * * *

* * * * *

14. Amend §107.1150 by revising the first sentence of the introductory text, redesignating paragraphs (c) and (d) and paragraphs (d) and (e), respectively, and adding a new paragraph (c) to read as follows:

§ 107.1150 Maximum amount of Leverage for a Section 301(c) Licensee.

A Section 301(c) Licensee, other than an Early Stage SBIC, may have maximum outstanding Leverage as set forth in paragraphs (a) through (c) of this section. An Early Stage SBIC may have maximum outstanding Leverage as set forth in paragraph (d) of this section. * * *

* * * * *

(c) Early Stage SBICs. Subject to SBA's credit policies, if you are an Early Stage SBIC:

(1) The total amount of any and all Leverage commitments you receive from SBA shall not exceed 100 percent of your highest Regulatory Capital or \$50 million, whichever is less;

(2) On a cumulative basis, the total amount of Leverage you have issued shall not exceed the total amount of capital paid in by your investors; and

(3) The maximum amount of Leverage you may have outstanding at any time is the lesser of:

(i) 100 percent of your Leverageable Capital, or

(ii) \$50 million.

15. Amend subpart I of part 107 by adding an undesignated center heading and §§ 107.1180, 107.1181, and 107.1182 to read as follows:

Subpart I – SBA Financial Assistance for Licenses (Leverage)

* * * * *

Special Rules For Leverage Issued By An Early Stage SBIC

Sec.

107.1180 Required distributions to SBA by Early Stage SBICs.

107.1181 Interest reserve requirements for Early Stage SBICs.

107.1182 Valuation requirements for Early Stage SBICs based on Capital Impairment Percentage.

* * * * *

§ 107.1180 Required distributions to SBA by Early Stage SBICs.

(a) Distribution requirement. If you are an Early Stage SBIC with outstanding Leverage, you may make Distributions to your investors and to SBA only as permitted under this section. See also § 107.585. For the purposes of this section, “Distributions” do not include required payments to SBA of interest and Charges and payments of Leverage principal at maturity, all of which shall be paid in accordance with the terms of the Leverage. You may make a Distribution on any Payment Date. Unless SBA permits otherwise, you must notify SBA in writing of any planned distribution under this section, including computations of the amounts distributable to SBA and your investors, at least 10 business days before the distribution date.

(b) How SBA will apply Distributions. Any amounts you distribute to SBA, or its designated agent or Trustee, under this section will be applied to repayment of principal of outstanding Debentures in order of issue. You may prepay any Debenture in whole, but not in part, on any Payment Date without penalty.

(c) Condition for making a Distribution. You may make a Distribution under this section only if you have paid all interest and Charges on your outstanding Debentures

that are due and payable, or will pay such interest and Charges simultaneously with your Distribution.

(d) SBA's share of Distribution. For each proposed Distribution, determine SBA's share of the Distribution as follows:

(1) Determine the highest ratio of outstanding Leverage to Leverageable Capital that you have ever attained (your "Highest Leverage Ratio"). For the purpose of determining your Highest Leverage Ratio, any deferred interest Debentures issued at a discount must be included in the computation at their face value.

(2) Determine SBA's percentage share of cumulative Distributions:

(i) If your Capital Impairment Percentage under § 107.1840 is less than 50 percent as of the Distribution date or your Highest Leverage Ratio equals 0.5 or less, except as provided in paragraph (d)(2)(iii) of this section, SBA's percentage share of cumulative Distributions equals:

$$[\text{Highest Leverage Ratio} / (\text{Highest Leverage Ratio} + 1)] \times 100$$

For example, if your Highest Leverage Ratio equals 1, then SBA's share of any distribution you make will be 50 percent.

(ii) If your Capital Impairment Percentage under § 107.1840 is 50 percent or greater as of the Distribution date and your Highest Leverage Ratio is greater than 0.5, SBA's percentage share of cumulative Distributions equals 100 percent.

(iii) If you have a condition of Capital Impairment under § 107.1830 and your Highest Leverage Ratio equals 0.5 or less as of the Distribution date, SBA's percentage share of cumulative Distributions equals 100 percent.

(3) Multiply the sum of all your prior Distributions and your current proposed Distribution (including Distributions to SBA, your limited partners and your General Partner) by SBA's percentage share of cumulative Distributions as determined in paragraph (d)(2) of this section.

(4) From the result in paragraph (d)(3) of this section, subtract the sum of all your prior Distributions to SBA under this § 107.1180.

(5) The amount of your Distribution to SBA will be the least of:

(i) The result in paragraph (d)(4) of this section;

(ii) Your current proposed Distribution; or

(iii) Your outstanding Leverage.

(e) Additional Leverage prepayment. On any Payment Date, subject to the terms of your Leverage, you may make a payment to SBA to be applied to repayment of the principal of one or more outstanding Debentures in order of issue, without making any Distribution to your investors.

§ 107.1181 Interest reserve requirements for Early Stage SBICs.

(a) Reserve requirement. If you are an Early Stage SBIC with outstanding Leverage, for each Debenture which requires periodic interest payments to SBA during the first five years of its term, you must maintain a reserve sufficient to pay the interest and Charges on such Debenture for the first 21 Payment Dates following the date of issuance. This reserve may consist of any combination of the following:

(1) Binding unfunded commitments from your Institutional Investors that cannot be called for any purpose other than the payment of interest and Charges to SBA, or the payment of any amounts due to SBA; and

(2) Cash maintained in a separate bank account or separate investment account permitted under § 107.530 of this part and separately identified in your financial statements as “restricted cash” available only for the purpose of paying interest and Charges to SBA, or for the payment of any amounts due to SBA.

(b) The required reserve associated with an individual Debenture shall be reduced on each Payment Date upon payment of the required interest and Charges. If you prepay a Debenture prior to the 21st Payment Date following its date of issuance, the reserve requirement associated with that Debenture shall be correspondingly eliminated.

(c) Your limited partnership agreement must incorporate the reserve requirement in paragraph (a) of this section.

§ 107.1182 Valuation requirements for Early Stage SBICs based on Capital

Impairment Percentage.

(a) If you are an Early Stage SBIC, you must compute your Capital Impairment Percentage and determine whether you have a condition of Capital Impairment in accordance with §§ 107.1830 and 107.1840 of this part.

(b) You must promptly notify SBA in writing if your Capital Impairment Percentage is at least 50 percent, even if your maximum permitted Capital Impairment Percentage is higher.

(c) Upon receipt of your notification under paragraph (b) of this section, or upon making its own determination that your Capital Impairment Percentage is at least 50 percent, SBA has the right to require you to engage, at your expense, an independent third party, acceptable to SBA, to prepare valuations of some or all of your Loans and Investments, as designated by SBA.

16. Amend § 107.1810 by revising paragraphs (f)(2)(ii) and (iii) and adding paragraphs (f)(2)(iv), (f)(11), (f)(12), and (j) to read as follows:

§ 107.1810 Events of default and SBA’s remedies for Licensee’s noncompliance with terms of Debentures.

* * * * *

(f) * * *

(2) * * *

(ii) Payments from Retained Earnings Available for Distribution based on either the shareholders’ pro-rata interests or the provisions for profit distributions in your partnership agreement, as appropriate;

(iii) Distributions by Participating Securities issuers as permitted under §§ 107.1540 through 107.1580; and

(iv) Distributions by Early Stage SBICs as permitted under § 107.1180.

* * * * *

(11) Failure by an Early Stage SBIC to meet investment requirements. You are an Early Stage SBIC and, beginning on the first fiscal quarter end when your cumulative total Financings (in dollars) are at least equal to your Regulatory Capital, you have not made at least 50 percent of such Financings to Small Businesses that at the time of your initial Financing were “early stage” companies, as defined under the definition of Early Stage SBIC in § 107.50 of this part.

(12) Failure by an Early Stage SBIC to maintain required interest reserve. You are an Early Stage SBIC and you fail to maintain a sufficient reserve to pay interest and Charges on your Debentures as required under § 107.1181 of this part.

* * * * *

(j) Additional SBA remedies applicable to Debentures issued by Early Stage SBICs. If you are an Early Stage SBIC, upon SBA's payment pursuant to its guarantee of any of your Debentures, SBA shall have the following additional rights and you consent to SBA's exercise of any or all of such rights:

(1) To prohibit you from making any additional investments except for investments under legally binding commitments you entered into before such payment by SBA and, subject to SBA's prior written approval, investments that are necessary to protect your investments;

(2) Until all Leverage is repaid and amounts related thereto are paid in full, to prohibit Distributions by you to any party other than SBA, its agent or Trustee;

(3) To require all your commitments from investors to be funded at the earliest time(s) permitted in accordance with your Articles;

(4) To review and re-determine your approved Management Expenses; and

(5) To the appointment of SBA or its designee as your receiver under section 311(c) of the Act for the purpose of continuing your operations.

17. Amend § 107.1840 by revising paragraph (d)(3)(iii) and paragraph (d)(4) introductory text to read as follows:

§ 107.1840 Computation of Licensee's Capital Impairment Percentage.

* * * * *

(d) * * *

(3) * * *

(iii) Except as provided for Early Stage SBICs in § 107.1845, such financing occurred within 24 months of the date of the Capital Impairment computation, or the Small Business's pre-tax cash flow from operations for its most recent fiscal year was at least 10 percent of the Small Business's average contributed capital for such fiscal year.

(4) Except as provided for Early Stage SBICs in § 107.1845, perform the appropriate computation from the following table:

* * * * *

18. Add § 107.1845 to read as follows:

§ 107.1845 Determination of Capital Impairment Percentage for Early Stage SBICs.

This section applies to Early Stage SBICs only. Except as modified by this section, all provisions of § 107.1840 apply to an Early Stage SBIC.

(a) To determine your Class 2 Appreciation under § 107.1840(d)(3), use the following provisions instead of § 107.1840(d)(3)(iii):

(1) Such financing occurred within 24 months of the date of the Capital Impairment computation. At the end of the 24 month period following the financing, you may request SBA's written approval to retain the use of the original Class 2 Appreciation on the investment for up to 24 additional months.

(2) In considering your request, SBA may obtain its own valuation of the investment, require you to obtain a valuation performed by an independent third party acceptable to SBA, and may consider any other information that it deems relevant. To the extent that the valuation and any other relevant information conclusively support the original Class 2 appreciation, SBA may approve an extension to use all or part of the original Class 2 Appreciation for up to an additional 24 months (the "extension period").

(3) At the end of any extension period, you may submit a new request to retain the use of the original Class 2 Appreciation, repeating the steps in paragraphs (a)(1) and (2) of this section.

(4) SBA may reconsider its approval to retain the use of the original Class 2 Appreciation at any time based on information that may affect the value of an investment.

(b) Any time you submit a request for SBA approval to retain the use of the original Class 2 Appreciation under paragraph (a) of this section, you may also request SBA's written approval to modify your computation of Adjusted Unrealized Gain under § 107.1840(d)(4) as provided in paragraph (c) of this section.

(c) If SBA determines that the appreciation on an investment, based on its current fair value, is at least two times the original Class 2 Appreciation on the investment, SBA may allow you, based on relevant information, to compute your Adjusted Unrealized Gain for the duration of the extension period as follows:

(1) Compute Adjusted Unrealized Gain in accordance with § 107.1840(d)(4).

(2) If your result in paragraph (c)(1) of this section was computed using the first line of the table in § 107.1840(d)(4):

(i) Calculate 50 percent of the original Class 2 Appreciation on the individual investment that is the subject of this paragraph (c), and

(ii) Add it to the result from paragraph (c)(1) of this section to determine your Adjusted Unrealized Gain.

(3) If your result in paragraph (c)(1) of this section was computed using the second line of the table in § 107.1840(d)(4):

(i) Calculate 50 percent of the original Class 2 Appreciation on the individual investment that is the subject of this paragraph (c).

(ii) Subtract your Class 1 Appreciation from your Net Appreciation, and multiply the result by 50 percent.

(iii) Add the lesser of (c)(3)(i) and (ii) of this section to the result from paragraph (c)(1) of this section to determine your Adjusted Unrealized Gain.

Karen G. Mills,
Administrator.

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